

# The Lingering Crisis of Neoliberal Capitalism

By Akbar E. Torbat

**September 10, 2011 "[Information Clearing House](#)"** -- After the Federal Reserve printed trillions of dollars to purchase the US debt securities (the so-called “quantitative easing” or monetizing debts) and the Federal government stimulative measures were applied in the past couple of years, it seems the American economic recovery has stalled. This became known when the government reported the updated economic growth rate for the first half of the year on July 29, 2011, which was much lower than expected. The disappointing news started a downward rollercoaster in Wall Street. That coincided with the sovereign debt crisis in Europe, which has posed problems especially in Greece, Spain, and Italy. The Euro zone debt crisis this year resembles the American financial meltdown in the autumn of 2008, as some major banks in Europe are vulnerable to possible sovereign debt defaults. In the meantime, a wave of political protests began in streets of Britain by the underprivileged class as had happened in the past several months in some other countries in Europe and the Arab States. All protests boiled down to the problem of unfair income distribution as a result of “neoliberal capitalism” economic policies that have caused the rich get richer and the poor get poorer. Neoliberal capitalism is a new form of capitalism in which the government plays a limited role in the economy and adopts austerity measures, which curtail state benefits to underprivileged class. Under this system a set of economic policies are adopted that includes promoting free market and privatization. In the past few years neoliberal capitalism has encountered structural problems of rising inequality and instability of financial markets. The shrinking income of the populous underprivileged class has led to unsustainable buildup of household debts and thus insufficient demand for the economy’s output. The deregulated financial system of neoliberal capitalism has made the financial market increasingly unstable and has led to new crisis that has shaken the system foundation. Despite of these problems, it seems its revival is still pursued by the financial elites throughout the world.

Since 1980 that President Ronald Reagan adopted neo-liberal economic policies, inequalities have substantially increased in the United States. More wealth has been accumulated by the super-rich and their political influence in the congress does not allow their income progressively taxed. In fact the extension of Bush tax cuts mostly benefited the rich rather than the poor and the middle class. As a result, the size of budget deficits has gradually increased and that has mounted the US national debt. Even though the government stimulative measures such as lowering pay roll taxes and extending unemployment payments to 99 weeks were helpful for the low income household and prevented a much deeper economic recession, but it could not generate sustainable economic recovery. The reason the economy does not respond to the stimuli is the structural problems of neoliberal capitalism. Strong economic recovery needs government investments in infrastructure and requires cutting much of the gasoline consumption by expanding mass transit. There is also a need for government investments in education to stimulate economic recovery. But that cannot happen due to public spending curtailment. The debt ceiling bill that was signed by President Barack Obama on August 2nd eliminated large public infrastructure spending, which was needed to modernize transportation and stimulate

employment and economic growth. Instead President Obama has continued to spend money on wars in Afghanistan, Iraq and Libya to maintain American hegemony in the oil rich region of the Middle East and North Africa. Obama has yielded to the demands of the wealthy while leaving the “change” he promised he would make for betterment of the underprivileged class on the shelf.

### **The Problem of Liquidity Trap**

The Wall Street Journal editorial on August 5 headlined "The Global Rout" blamed the lingering crisis on failed Keynesian policies, saying “the Keynesians fired all their ammo and here we are.” Not true because it is the Fed that has run out of Ammo rather than Keynes inspired policies. What the Fed has done so far is monetizing government debt to cure the lingering problems of neoliberal capitalism.

Keynesian economic policies help stabilize the economy because peoples’ lack of purchasing power can be cured by government investments, which in turn creates employment and income. Neoliberal economics minimize the role of government interventions. In the absence of government spending, the free market can only work if under-consumptions can be remedied by banks’ credits to low-income strata to keep consumption going. The economy works temporarily by spending on credit, which provides demand for goods and services, and thus unsold products are cleared from the market. But when people cannot afford to pay back their debts, the economy runs to crisis. In this situation, lowering interest rates does not revive the economy, because it will create the problem of “liquidity trap” as is called in Keynesian economics. This happens when the banks do not lend money to financially weak individuals and companies due to risk of default. Also investors and corporations with liquid assets are unwilling to invest in such economic conditions. In that situation monetary policy is unable to stimulate the economy by lowering interest rates or by increasing the money supply.

Evidence of liquidity trap became evident as the Bank of New York Mellon announced on August 4 that it would charge 0.13% fee to the large depositors that have more than \$50 million idle cash in the bank for the privilege of holding their cash. That meant interest rate has technically turned negative. At the time, the bank had \$165.5 billion in cash deposits. The fact is that too much money has been accumulated in the US banks, while not much money is demanded for investments. People who are under financial distress are borrowing for their consumptions but there is not much corporate borrowing for investments. That is because the corporations do not see strong economic recovery in the US. The measures that were taken to supplement the failed neoliberal policies could not generate sustainable economic recovery. Policy makers thought they could save neoliberal capitalism by quantitative easing but that has not worked well.

### **What has “Quantitative Easing” Done?**

Since the peak of global financial crisis in 2008, the Fed has tried to revive the American economy by its money machine and that brought the short-term interest rate nearly to zero. The Fed Quantitative easing did not stimulate new investments. It only created a wave of refinancing in the bond market and helped bailing out the insolvent banks. By printing nearly three trillions

of newly created money, the Fed converted the private banks' debts to public debt to prevent the banks bankruptcies. The banks were able to have to access depositors' money with near zero interest rate and could borrow from the Fed at negligible cost. According to the Bloomberg News, the Fed secretly lent \$1.2 trillion to major financial institutions during the peak of financial crisis. The public money partly compensated the losses that the banks had suffered from the subprime mortgage meltdown of 2008. However, low interest rates increased speculations in the commodity and stock market similar to real estate speculations before the global financial crisis in 2008. Since money could not earn interest in the bank, it was used to buy financial securities or speculative commodity contracts. Buying the already issued securities in the stock market is not investment in economic sense because it only transfers the money from the buyers to the sellers of securities through transactions in the stock exchanges and the money does not go to the corporations for investment in new plants and equipments or hiring new workers. Only buying the newly issued stocks are true investments in economic sense. Too much speculative transactions have made the stock markets resembling a "big casino". Susan Strange (1986) called the modern financial markets "Casino Capitalism" because of being globally unstable and uncontrollable.

Quantitative easing also has weakened the US dollar. The United States debauch the dollar at the expense of its creditors. US maintains near zero interest rate by letting its central bank buy its treasury bonds. The dollar index has fallen almost 40% since 2002. US benefits from weak dollar because most of its foreign debt is denominated in its own currency. Lower dollar price causes the value of US bonds held by foreigners go lower versus their own local currency or real money that is gold. Due to delinking of gold from dollar in 1971, which had been established by the Bretton woods agreement after the World War Two, the world monetary system is debased. Fiat moneys such as the dollar and euro have lost their values versus real money that is gold. That is the reason the price of gold has gone up sharply. On August 22, 2011 the weak dollar increased the price of gold to a record high of \$1898 per troy ounce, which was 238% higher than the price of \$561 per troy ounce it had reached in the summer of 2006 according to Kitco Metals Inc. Recently China that is the largest holder of dollar denominated bonds has called for the creation of a new currency to replace the dollar as worldwide currency. The concern over economic recovery and sovereign debt crisis has caused a sharp decline in stock prices worldwide.

### **The tumbling of Stock Prices**

The financial market turmoil in summer of 2011 will go on record as a momentous period in the history of financial crisis. A sequence of unexpected economic news began to surface in July that showed the economic recovery in the US had been anemic. On Friday July 29, it was announced the First-quarter gross-domestic-product (GDP) growth rate in 2011 had been revised from an initial estimate of 1.9% down to 0.4% and the second-quarter growth rate was 1.3% much lower than 1.9% economists had expected. That news shook the stock market throughout the globe. Until then there was a hope that economic growth in the US would help to bring the lingering economic crisis to the end but that did not happen. Moreover, Germany reported that its economy grew in the second quarter just .1% and France growth in the same quarter was zero. All these reports in August painted a gloomy picture of economic recovery in the Western world.

On August 1, 2011, the Republicans and Democrats in the Congress who were fighting over the

limit of US national debt ceiling ultimately came to consensus and voted on the bill, and the President signed it on August 2. The compromised bill reduced the government spending by \$2.1 trillion over a decade and the new national debt ceiling was raised to \$16 trillion until 2012. The terms of the consensus on the government spending caused concern in the financial market. It eliminated hope of economic recovery and increased the chance of a double-dip recession. The Wall Street economists who mostly have Keynesian orientation, quickly figured out that curtailing government spending could push the economy back into recession. As a result, sell orders flooded the stock exchanges to cash out stocks. The money flew out of the risky stock market and flew in to money market funds, gold, and US treasury bonds. In the following days, the Stock market indexes nose dived to a new low for the year.

On August 4, 2011, the financial markets around the world declined sharply in a hectic day. It began in Europe and then in the US. The Dow Jones Industrial average fell 4.3%, S & P 500 4.8%, and Nasdaq by more than 5% in that day. That was the sharpest stock market decline since the height of financial meltdown on October 22, 2008. On Friday August 5 the news of monthly payroll statistics was a little better than expected, however that did not reverse the market mood. Overall, the Dow fell 5.75%, S&P 500 7.2%, and Nasdaq 8.13% in the first week of August, the biggest weekly drop since October 2008. The losses on bank stocks were much more severe than the overall market. It has been estimated that in that week about \$3 trillion was shaved off the value of global stock prices.

Moreover, after the market closed on August 5, the bond rating agency Standard & Poor's downgraded the US debt securities from its highest level AAA rate to one notch lower AA+. S & P said, the deficit reduction passed in the congress was not enough to protect US triple rating. That was the first US debt downgrade since 1917. Similarly, on August 8, Standard & Poor's downgraded credit ratings on debt issued by U.S.-backed lenders including the mortgage giants Fannie Mae and Freddie Mac. As a result of the downgrades, the stock market further dipped on Monday August 8, DJ lost 5.55%, Nasdaq 6.9%, and similar decline happened in other major markets around the world. The Mortgage giants own or guarantee more than half of the almost \$11 trillion U.S. mortgage debt outstanding. S&P said the downgrade reflects the companies' direct reliance on the U.S. government support. Other downgrades might be on the horizon for a number of states, municipalities, and insurance companies. Even though AA+ still is above average investment grade rating, but should US financial position deteriorate further, the rating could go below investment grade, which means the expectation of debt repayment becomes doubtful. Although the US government always can pay its debt by printing new money, but if that happens, it will increase the rate of inflation and will push down the US Treasury bonds prices substantially.

Seeing the turmoil in the global financial market, the European Central Bank announced it would buy the Italian and Spanish government bonds. Also, France, Spain, Italy and Belgium banned short-selling but that did not reverse the fall in stock prices. On August 9, the Fed announced, it would keep the short-term interest rate near zero for two more years until 2013. The announcement partly cut the losses in the US stock market. However, the major indexes fell about 5% on August 10, and partly recovered in the following days. But on August 18, further macroeconomic data revealed that the US economy would further slow down. That news pushed the stock prices further down by the end of the week on August 19. Whether the lingering

economic crisis will push back the economy to recession or the economy will recover remains to be seen.

*Akbar E. Torbat (atorbat@calstatela.edu) teaches economics at California State University – Los Angeles. He has published a number of articles in scholarly journals concerning international Political/economic affairs and has served as a financial advisor. He received his Ph.D. in political economy from the University of Texas at Dallas.*